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News

Fed Faces Explaining Billion-Dollar Losses in QE Exit Stress

Federal Reserve Chairman Ben S. Bernanke's efforts to rescue the economy could result in more than a half trillion dollars of paper losses on the central bank's books if interest rates rise abruptly from recent levels.

That sum is the difference between the value of securities in the Fed's portfolio on Dec. 31 and what they may fetch in three years, according to data compiled by MSCI Inc. (MSCI) of New York for Bloomberg News. MSCI applied scenarios devised by the Fed itself for stress-testing the nation's 19 largest banks.

MSCI sees the market value of Fed holdings shrinking by $547 billion over three years under an adverse scenario that includes an economic contraction and rising inflation. MSCI puts the Fed's mark-to-market loss at less than half that, or $216 billion, if the economy performs in line with consensus forecasts of gradually rising growth, inflation and interest rates.

The potential losses are unprecedented in the Fed's 100- year history. Bernanke began describing in detail the risk of lower payments to taxpayers for the first time today in his monetary policy testimony before the Senate Banking Committee saying that "remittances to the Treasury could be quite low for a time" if interest rates "were to rise quickly." Bernanke didn't describe the overall interest-rate risk to the portfolio or potential mark-to-market losses. He said the Fed is "confident" it has tools to tighten monetary policy.

The Marriner S. Eccles Federal Reserve building stands in Washington, D.C. The Fed doesn't mark its portfolio to market, and its losses may be only a fraction of MSCI's totals because the central bank could hold the bulk of its assets to maturity. Photographer: Andrew Harrer/Bloomberg

WHERE'S MONEY?

"You can easily imagine a naive congressional response, which is 'Where did the money go?' " said Sarah Binder, a senior fellow at the Brookings Institution who researches the relationship between the Fed and Congress. "Even if there's a perfectly logical explanation and the normalization of the balance sheet is a good thing in the long term, the headlines will probably generate congressional scrutiny," said Binder. "That's never a good thing from the Fed's perspective."

The risk of mark-to-market losses under some scenarios is the price of Bernanke's battle to overcome the deepest recession since the Great Depression as the Fed embarked on three rounds of so-called quantitative easing. The benefit is more jobs and higher growth, Fed officials say.

"To the extent that monetary policy promotes growth and job creation, the resulting reduction in the federal deficit would dwarf any variation in the Fed's remittances to the Treasury," Bernanke said in today's testimony.

CORKER INQUIRY

Senator Bob Corker, a Republican from Tennessee, sent Bernanke a follow-up letter this afternoon asking for the central bank to provide further details about how losses would affect the Fed's operations.

"Do we have a serious policy problem brewing here, or is this simply an optics problem about which we should not be concerned?" Corker asked.

The Fed doesn't mark its portfolio to market, and its losses may be only a fraction of MSCI's totals because the central bank could hold the bulk of its assets to maturity. The central bank

cannot go bankrupt and can continue to operate with losses on its books.

"There's a cost to very significant stimulus — and that's OK if the stimulus is a good investment — and I think a lot of what the Fed has done is a very, very good decision," said Representative John Delaney, a Maryland Democrat and member of the House Financial Services Committee, where Bernanke testifies tomorrow. "Their actions right now are having diminishing returns and increasing the severity of this future loss that will be incurred as rates go up."

BERNANKE'S LEGACY

Bernanke's legacy will be judged in part by how the Fed exits from its emergency policies, a prospect that is already troubling the Federal Open Market Committee and some members of Congress. Bernanke, 59, ends his second four-year term as Fed chairman on Jan. 31, and he hasn't said whether he wants to stay in the job after that.

Four economists, including Frederic Mishkin, a former Fed governor and co-author with Bernanke, argued in a paper presented in New York on Feb. 22 that the central bank's grip on policy may weaken if losses coincide with high U.S. budget deficits and an inability of Congress and the White House to put fiscal policy on a sustainable path.

"This mix could induce a bias toward slower exit or easier policy, and be seen as the first step toward fiscal dominance," the economists said in the paper, presented at the U.S Monetary Policy Forum, referring to fiscal influence on monetary policy. "It could thereby be the cause of longer-term inflation expectations and raise the risk of inflation overall."

FED'S FLEXIBILITY

In response, Fed Governor Jerome Powell said at the conference that policy makers "have the flexibility to normalize the balance sheet more slowly" to avoid taking losses and causing market disruptions. He said there's "no reason" to expect the Fed won't act to prevent inflation.

Boston Fed President Eric Rosengren said that "this discussion does not do justice to the policy trade-offs" of the central bank's quantitative easing, because the stimulus boosts growth and also improves the fiscal outlook by lowering borrowing costs.

Now, it's Bernanke's turn to convince lawmakers.

"When they start losing money — that is going to be a big issue" on Capitol Hill, said Hester Peirce, a former senior counsel to Republican staff on the Senate Banking Committee who is now a senior research fellow at the Mercatus Center at George Mason University in Arlington, Virginia. "There will be more pressure to watch the Fed closely."

Bernanke is implementing the most aggressive monetary policy in the central bank's history to support growth and employment. After the Fed's benchmark rate was cut to a range of zero to 0.25 percent in December 2008, the chairman began buying more bonds to lower longer-term financing costs for home buyers, companies and consumers.

TOTAL ASSETS

Three rounds of quantitative easing, including the current phase where the Fed is buying $85 billion in longer-term Treasury bonds and mortgage-backed securities a month until the labor market shows substantial improvement, have pushed the Fed's total assets to more than $3 trillion, from $869 billion in mid-August 2007 when the financial crisis began.

Fed officials say the portfolio's size and even potential losses are a byproduct of its pursuit of stable prices and maximum employment, the two policy goals mandated by Congress.

At the same time, they have encouraged the public to view the portfolio in profit-and-loss terms by emphasizing its earnings in recent years. Officials in conference calls with reporters describe how returns on the expanding balance sheet have generated higher profits that the Fed gives back to taxpayers in the form of remittances to the U.S. Treasury. Vice Chairman Janet Yellen, in Feb. 11 remarks in Washington, said the strategy benefits the economy as well as federal finances.

'CREDIT EASING'

The Fed creates money to buy Treasury debt, mortgage-backed securities and federal housing-agency debt. Bernanke calls the policy "credit easing." As prices rise on the bonds the Fed purchases, yields fall and investors seek higher returns in other fixed-income securities, pushing a broad array of financing costs lower throughout the economy.

The Fed's cost of funds is low because there is no interest expense for it to issue currency, and it pays banks just 0.25 percent on reserves the central bank creates to buy assets. This helps maximize the return on the Fed's portfolio.

After paying for its own expenses and making capital adjustments, the Fed returns the remainder of its earnings to U.S. taxpayers. The Fed remitted a record $88.9 billion to the Treasury in 2012 and $75.4 billion in 2011, compared with $31.7 billion in 2008.

ENRICHING TREASURY

The earnings that are enriching the Treasury now may shrink as interest rates rise, driving down returns from the Fed's holdings. Remittances may even disappear for a few years, according to Fed researchers who published a paper on the balance sheet last month.

At the same time, the Fed's portfolio will be shrinking in value as the higher rates erode the market price of the securities it contains.

Representative Jim Jordan, an Ohio Republican who chairs a subcommittee of the House Committee on Oversight and Government Reform, asked Bernanke in a Feb. 19 letter for more details about the portfolio's risks.

"Such a large portfolio could cause significant problems when the Federal Reserve begins to unwind," he said in his letter.

SUSTAINED GROWTH

"The Federal Reserve has played and is currently playing a major role in fostering the sustained economic growth we've seen over the past few years," said Matthew Cartwright, a Pennsylvania Democrat and ranking member on the House Oversight Committee's subcommittee on economic growth, job creation, and regulatory affairs. "The role of the Federal Reserve is to stabilize the economy and help it grow at a healthy rate through the enactment of monetary policy, balancing interest rates with unemployment—its role is not to make money."

The Fed's own exit strategy calls for selling mortgage-backed securities after it begins to raise interest rates. The Fed only records a loss on its bond holdings if they are sold. If losses from bond sales, and the interest the Fed pays to banks to fund its assets, exceeds income, the Fed accounts for it as a "deferred asset."

POLITICAL BACKLASH

"The political backlash could be particularly acute given that a good portion of the funds that would otherwise be remitted to the Treasury would be transferred to large financial institutions in the form of interest paid on reserves," said Laurence Meyer, a former Fed governor and co-founder of Macroeconomic Advisers LLC in St. Louis. "This could present a significant communication challenge for the Fed and adversely impact its reputation."

MSCI calculated potential losses and gains to the central bank's portfolio by running the same three scenarios the Fed is using this year to stress-test the capital of the 19 largest banks.

The baseline scenario is similar to a consensus forecast for the economy's performance in which growth continues. Under the adverse scenario, the economy contracts for six quarters while inflation rises, with the consumer-price index reaching 4 percent. In a severely adverse scenario, the economy falls into a deep recession and interest rates decline.

MSCI provides investment, analytic and risk-management tools to some 6,200 clients around the world, operating in 22 countries with more than 2,700 employees. Its products include a suite of portfolio-risk and performance analytics, stock indexes and corporate

governance tools such as proxy research. One of the firm's brands, RiskMetrics, developed the widely-known value-at-risk model, or VAR, in 1994.

10-YEAR YIELDS

MSCI's data showed the greatest losses under the adverse scenario, as 10-year Treasury yields jump to 5.4 percent by the end of 2015 and three-month rates rise to 4 percent. The 10-year yield was 1.86 percent yesterday, and the three-month rate was 0.117 percent.

Because the Fed deliberately lengthened the maturity of its portfolio by selling short-term notes and bills and buying bonds from September 2011 until December 2012 in a program dubbed Operation Twist, "Treasury performance dwarfs what is happening in the other books" of agency and mortgage debt, said Ron Papanek, executive director of MSCI.

"They have a lot of long bonds that are going to be hit in a rising rate environment," Papanek said.

PORTFOLIO LOSS

Losses on the Fed's portfolio rise steadily under the adverse scenario to $547 billion by the fourth quarter of 2015 in the MSCI analysis, which is purely a measure of interest-rate risk in the portfolio starting from bond prices at year end. It does not take account of purchases or sales the Fed may conduct in the future. The calculations are mark-to-market losses on the portfolio that take account of yield, amortization, accretion, and funding costs.

The Fed portfolio also loses money under the baseline scenario, in which economic growth accelerates to a 3 percent annual pace in the final quarter of 2015 and the inflation rate is 2.4 percent. This compares with Fed officials' own estimate of 3 percent to 3.7 percent growth in 2015 and inflation of 1.7 percent to 2 percent. With three-month Treasury bill rates at 1.9 percent and 10-year yields at 3.9 percent, the Fed's portfolio losses rise to $215 billion in the fourth quarter of 2015, according to MSCI's analysis.

Because the Fed's severely adverse scenario envisions a deep recession, little movement in short-term rates and a gradual rise in long-term rates, its portfolio posts a mark-to-market gain of $84 billion by the fourth quarter of 2015 in MSCI's analysis.

Some Fed officials are wary of how the central bank intends to account for the losses and how Congress might react.

'APPEARANCE ISSUE'

"I am concerned about this issue," St. Louis Fed President James Bullard said in a Feb. 1 interview in Washington. Bullard advocates holding some remittances back in the form of reserves now to serve as a buffer against losses later. "The appearance issue is a serious one and we should take it seriously," he said.

The practice of accounting for losses as a deferred asset is among questions congressional leaders are raising.

"I don't think we will buy that," said Republican Representative John Campbell of California, a certified public accountant who chairs a monetary policy subcommittee on the House Financial Services Committee. Fed portfolio losses are "a legitimate concern and something we will be watching."

Fed officials say the portfolio losses should be viewed in comparison with the Fed's cumulative remittances to the Treasury, which have totaled $448 billion over the past decade.

STAFF PAPER

In the past, officials have warned that they are taking on interest-rate risk, and a recent paper by Fed Board staff attempted to quantify how that would affect their payments to the Treasury.

The analysis led by Seth B. Carpenter, senior associate director in the Fed Board's Division of Monetary Affairs, shows that, assuming another $1 trillion of bond purchases under the current quantitative-easing program, remittances to the Treasury will fall to zero for about four years under a baseline economic outlook with gradually rising interest rates.

The Fed's portfolio had $249 billion in unrealized gains as of the end of September, according to the paper.

Under a more aggressive interest-rate increase scenario, remittances are halted for about six years, as "higher short-term interest rates make interest on reserves more costly, and higher long-term rates make selling MBS more costly," according to Carpenter's analysis.

YELLEN SPEECH

"There is a chance when we could go through a period of time in which our income falls and we could even take losses if we decide to sell," Yellen said in response to audience questions after a Feb. 11 speech. "It is possible that in the course of trying to carry out monetary policy that there will be a period of a year, or even several years, in which those remittances fall to zero."

Minutes from their January meeting show "many participants" on the FOMC worrying about how to exit from the bond portfolio with "several" noting the Fed could be exposed to "significant capital losses."

The Fed wouldn't be the first central bank to lose money from its policies, said Nathan Sheets, formerly the Fed's top international economist.

Central banks in Switzerland, Chile, Mexico have taken losses that did not prevent them from conducting monetary policy, he said.

There is a good news side to the story as well, he added.

"It's often thought that if you incurred a loss you made a mistake and didn't handle resources properly," said Sheets, now global head of international economics at Citigroup Inc. in New York. "In central banking that presumption is turned on its head," Sheets said.

"If recovery occurs then bond prices may fall," he said. "But it's not a failure in your policy, it would reflect a success of your policy" as economic growth picks up and the Fed can finally stage an exit.

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